Task Force Meeting

of

ASSEMBLY TASK FORCE ON FISCAL RESPONSIBILITY

State Treasurer John E. McCormac addresses issues related to State-administrated pension funds

LOCATION: Committee Room 11
State House Annex
Trenton, New Jersey

DATE: October 31, 2002
1:00 p.m.

MEMBERS OF COMMITTEE PRESENT:

Assemblyman Joseph J. Roberts Jr. (Chair)
Assemblyman John J. Burzichelli
Assemblyman Wilfredo Caraballo
Assemblyman Jerry Green
Assemblywoman Joan M. Quigley
Assemblyman Paul A. Sarlo
Assemblyman Michael J. Doherty
Assemblyman Guy R. Gregg

ALSO PRESENT:

Alan R. Kooney
Office of Legislative Services
Task Force Aide

Mary Messenger-Gault
Assembly Majority
Task Force Aide

Beth Schemerhorn
Assembly Republican
Task Force Aide

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TABLE OF CONTENTS

hw: 1-70

ASSEMBLY JOSEPH J. ROBERTS Jr. (Chairman): Ladies and gentlemen, if you could all take a seat. We're going to try and get started.

I am pleased to welcome you to this most recent meeting of the Assembly Task Force on Fiscal Responsibility.

Roll call, please.

MR. KOONEY: (Task Force Aide): Assemblyman Roberts.

ASSEMBLYMAN ROBERTS: Here.

MR. KOONEY: Assemblyman Burzichelli.

ASSEMBLYMAN BURZICHELLI: Present.

MR. KOONEY: Assemblyman Caraballo. (No response)

Assemblyman Green. (No response)

Assemblywoman Quigley.

ASSEMBLYWOMAN QUIGLEY: Here.

MR. KOONEY: Assemblyman Sarlo.

ASSEMBLYMAN SARLO: Here.

MR. KOONEY: Assemblyman D'Amato. (No response)

Assemblyman Doherty.

ASSEMBLYMAN DOHERTY: Here.

MR. KOONEY: Assemblyman Gregg.

ASSEMBLYMAN GREGG: Here.

ASSEMBLYMAN ROBERTS: Assemblyman D'Amato, who has been very faithful with his attendance, is unable, unfortunately, to be with us today. Assemblyman Caraballo is en route. Assemblyman Green is here, and will be with us in just a moment.

We are here today to deal with the financial issues related to the State administered pension fund. We have invited John McCormac, the State Treasurer, to be with us.

Treasurer, good afternoon. I know you've brought a couple of folks with you. And, perhaps, you'd like to make some opening comments and introduce the people here with you.

TREASURER JOHN E. McCORMAC: Thank you, Assemblyman.

Chairman Roberts and members of the Task Force, thank you for the invitation to appear before you today. On behalf of the administration, I share your interest in maintaining an open dialogue with the Legislature over matters of fiscal importance to the State and New Jersey's taxpayers.

In my last appearance before this Task Force, we reviewed the revenue estimating process in New Jersey. Following your hearings, the Treasurer's Office prepared and distributed a request for proposal to solicit consultants for a management review of our forecasting process, procedures, and methodologies. Our goal is to identify the best practices in state tax revenue estimating. Our budget simply cannot withstand another year of revenue collections that fall billions of dollars short of targets, as we experienced in the last budget cycle.

Similarly, our goal, as we move forward with New Jersey's pension investment portfolio, is to identify how to address the mounting losses that have pushed the value of our funds down to disturbingly low levels. We recognize risks are inherent in investing. We recognize that investments, in general, have been hit hard by the downturn in financial markets. These factors, however, do not explain why New Jersey's investments performed poorly in comparison to pension funds of other large states, and underperformed significantly against our own internal benchmarks. Also unexplained is why there have been no changes in investment strategies, despite losses that continue to mount.

As Treasurer, I have a fiduciary obligation to ask questions and review decisions and conditions that have contributed to poor investment performance. I have the duty and responsibility of protecting New Jersey's investment portfolio on behalf of current and future beneficiaries of the pension system and on behalf of the taxpayers of our state.

I welcome the opportunity to discuss how best to fulfill these obligations and to work with you on ways to improve New Jersey's pension portfolio performance.

At this time, I'd like to introduce, to my left, your right, Jeanne Cullins, from the firm of Independent Fiduciary Services, from Washington and Newark, a representative of the firm who was selected to do our operational audit process, which is recently begun; and, to my right, Orin Kramer, who was appointed to the Investment Council, back in March, and in September was appointed as its chairman.

I'd like to ask Mr. Kramer if he'd also like to make an opening statement.

ASSEMBLYMAN ROBERTS: Thank you.

Mr. Kramer, good afternoon.

O R I N K R A M E R: Thank you, Mr. Chairman. I appreciate the opportunity to be here. Since I, actually, didn't know until last night I was going to be here -- I guess this one -- (referring to microphone) I have no formal --

ASSEMBLYMAN ROBERTS: Make sure the little red light is on there, and we'll be in business.

MR. KRAMER: Got you, okay.

Let me just try to briefly review, in the six weeks since I've been chair, what the priorities have been.

Number 1, in the past, Council members -- Council chairs, had not actually met with Division staff. I've spent a fair amount of time with Division staff. It's important in terms of both understanding the risk issues and their concerns, and, also, building a morale during a difficult period.

Secondly, and I guess it will be a lot of the meat of today's discussion, I've done a fair amount of work in terms of the performance, the risk controls, and the risk levels in New Jersey over the last three years, five years, ten years. And the purpose, really, over the last few weeks, has been to try and meet with as many legislators or constituency groups, who have an interest in these issues, so they can understand that we have had above average losses, and we do have a substantially above average risk profile, which we've had for a number of years. And that we -- certain risk controls, which are common in other large institutional funds, don't exist in New Jersey.

Number 3, I think that, over the next several weeks, we will be trying to introduce some rudimentary risk controls.

And finally, it isn't an issue that's been in the press as much, but we have been trying to break the mold in terms of New Jersey's traditional lack of activity on the corporate governance front. The traditional posture in New

Jersey, which actually changed at our last meeting, is that New Jersey does not speak up on corporate governance issues, and that it is impolite to act publicly in any manner, when the shareholders, the beneficiaries of the fund, and ultimately, therefore, the taxpayers of New Jersey, are hurt by corporate actions. And I think that's in the process of changing fairly rapidly.

I'll stay away from the substance of that. We can do it on your schedule.

ASSEMBLYMAN ROBERTS: Sure, thank you very much.

I know that the members of the Committee have a fair number of questions, and I'd like to begin with Assemblywoman Joan Quigley.

ASSEMBLYWOMAN QUIGLEY: Thank you, Mr. Chairman.

Mr. Treasurer, I'd like to begin with the basics. What is the value, today, of New Jersey's pension fund portfolio -- or if not today, the closest date you could estimate?

TREASURER McCORMAC: The most recent estimate, Assemblywoman -- or most recent actual figure, I should say -- was September 30, at $56.3 billion.

ASSEMBLYWOMAN QUIGLEY: We had heard a couple of years ago that New Jersey's portfolio was way up there. What was our peak, and when did we reach it?

TREASURER McCORMAC: The high value appears to be in June of 2000, at approximately $83 billion. So we're down, from 83 to 56 in that period.

ASSEMBLYWOMAN QUIGLEY: Even considering this is Halloween, that's a pretty scary thought. When did that drop occur? Did that all happen in the last year, or was it progressive all the time?

TREASURER McCORMAC: It appears, from the statistics, that the drop started in early 2000 and has continued through this last quarter.

ASSEMBLYWOMAN QUIGLEY: It's been steady?

TREASURER McCORMAC: Of the last 11 quarters, we have underperformed our own internal benchmark in 9 of those 11 quarters.

ASSEMBLYWOMAN QUIGLEY: Well, now, just about everybody I know is complaining that what the market activity is doing is hurting them. Is New Jersey being hurt on a par with every other state, or are we performing worse?

TREASURER McCORMAC: That gets to the crux of what we think the problem is. Certainly, everybody has lost money in their IRAs, their 401(k)s, their pension plans. Our pension plan has lost money. But in order to properly evaluate our position, we need to look at our peers, and our peers consist of large, publicly traded pension funds. And there's no doubt that over the last three years, we have performed exceedingly poor compared to our peers -- over the last five and ten years, have not kept pace with our peers -- but especially over the past three years, we are far below where similarly sized public pension funds are. In fact, had we performed on an equal par with our peers over the past several years, we'd have about $7 billion more in our fund right now. Had we performed in line with our own internal benchmarks, we'd have 2 billion more in the fund than we have right now.

So there's clearly a problem everywhere. Markets are down. But we, without a doubt, are worse than people like us, which are similarly sized, large pension funds -- public pension funds.

ASSEMBLYWOMAN QUIGLEY: Why? What caused this? What has gone wrong, so that we have performed so poorly in comparison to everyone else?

TREASURER McCORMAC: Well, I think that's the purpose of our operational audit. We want to get to the bottom of why we're at the bottom. We've asked -- we went out for request for proposals back in July, for firms to come in and do a fiduciary audit, also called an operational audit. We had 10 responses. In August, we interviewed the top three firms, in person, and selected Independent Fiduciary Services -- again, out of Washington and Newark -- to do this study. The charge of that study is to answer that question. It's going to look at a wide variety of issues. It's going to look at staffing, compensation, training, research, asset allocation, risk tolerance, policies -- a wide array of aspects of the operation of the pension fund, to determine if any of those are the reason why we are underperforming. It would be premature to say what any conclusions would be, but we intend to get to the bottom of that very question.

ASSEMBLYWOMAN QUIGLEY: Well, even though you are not ready yet to bring out any conclusions, what -- when did you first notice that something was wrong, that something had to be done, and what were the steps you took right from the get go?

TREASURER McCORMAC: Well, back in the spring, we alerted the Investment Council that we believed the fiduciary audit was necessary. It was our third or fourth month in office, and we alerted the Council that we thought this step needed to be taken. And then, in the next 60 days or so it took to work up the request for proposals, they were sent out -- another 30 to 60 days for responses to be received, and then time for interviews. And we made the award, I believe, in September. So -- but the performance of the fund has been, I'd day, sub par, for approximately the last three years.

ASSEMBLYWOMAN QUIGLEY: Who actually sets the policy for New Jersey's investments?

TREASURER McCORMAC: The policies are the discretion of the Investment Council, in terms of asset allocation. And then, the Investment Division and the Treasury are responsible for the implementation of those policies, through proper practices and procedures and methodologies.

ASSEMBLYWOMAN QUIGLEY: And you're looking at all those things?

TREASURER McCORMAC: Everything.

ASSEMBLYWOMAN QUIGLEY: Well, I will let my fellow legislators, then, ask you the balance of the questions, and maybe I'll pop in from time to time. But just in a simple sentence or two, how would you characterize our performance in the pension fund in the last couple of years -- investment funds, in the last two years, say?

TREASURER McCORMAC: Unacceptably below par.

ASSEMBLYWOMAN QUIGLEY: I agree with you. Thank you.

ASSEMBLYMAN ROBERTS: Assemblywoman, thank you very much.

Next, Assemblyman Sarlo.

ASSEMBLYMAN SARLO: Thank you, Mr. Chairman.

And thank you, Mr. Treasurer, Mr. Kramer, and Ms. Cullins.

I know we've identified that we do have a performance problem, and I'm sure we're going to get -- I may be jumping ahead here, but I just want to take a moment, and whoever can answer me, please jump in. I'm talking about the operational side of this, for the moment.

Just commenting for the Committee, can you, kind of, describe the process, by the Division of Investment, how we come up with these investment decisions -- just the process behind it.

TREASURER McCORMAC: I would think both of us, Mr. Kramer and myself, could probably answer that. But I'll just start by saying there's about 62 employees in the Division, counting professional staff and nonprofessional staff. They're broken down into analysts, traders, portfolio managers, secretarial support, accountants, and, of course, the directors of the divisions. Mr. Kramer probably has a better handle on the actual methodologies for trading, so I will let him chip in on that one.

MR. KRAMER: I've been focused, actually, more on the risk controls, which is the province of the Council, as opposed to the day-to-day operation. And let me just preface what I'm about to say by saying this is genuinely not, in any way, critical of the Division staff, because, actually, every one of the issues I'm about to cite are areas where it's about Council policy. And the Division staff would be happy to comply with whatever demands are made by the Council.

And I wouldn't want to be too harsh on the Council, either, because one could argue that times and conditions change, etc.

But, if you want to talk about the control issues that rise to the level that I think this body should be thinking about, as opposed to, actually, how they make individual investment decisions, Number 1, effectively, there are no limits in New Jersey as to how overweighted the State can be in one name. We can't own more than 5 percent of a company. More than 4 percent of the portfolio can't be in one name. But beyond that, there are no limits on overweighting.

There is a philosophical argument that says it's okay to substantially overweigh America Online, even though it actually cost us $800 million, or that a billion dollar overweight in Sun Microsystems would be okay. There is that philosophical argument. But those who would argue, I want to give total discretion to the investment manager to make that decision, or the staff, would usually then come down on the side of saying, "However, when you're making a large bet -- a large overweight -- I want that reported to the Council, and I want it progressively reported, how much we're ahead, or how much we're behind on that bet, so at least we can ask questions." And that's something that doesn't exist in New Jersey.

Number 2, there are no limits on the size of industry bets. Again, someone might argue, I, as a manager, want discretion to make unlimited industry bets. Personally, I'd be uncomfortable with that as a policy matter. But if someone made that argument, then you'd say, "Well, at least let's have disclosure of the size of the industry bets." Instead, because we don't make that disclosure, and we don't disclose to the Council the outcome of the bets, the Council would have had no way to know that we had a two-and-a-half times overweighting in media companies, and we also owned the wrong stocks, and, as a consequence, we lost $1.8 billion. Some other area, during some other period, the overweighted, that would have worked. But the point is that there is no disclosure. There is no reporting on how we're doing. The Council wouldn't have had any way to know that we had a $680 million overweight bet on Internet -- I'm sorry, we lost 688 -- $680 million through our Internet software, overweighted bet.

Again, it's not so much that the bet didn't work, it's that there's no disclosure of the fact of the bet. There's no monitoring by the Council to find how are we doing, what are the gains and losses.

International Equity Portfolio: We already have a problem that we've got a portfolio managed by people that, if you look at their travel budget relative to the number of countries that they're in, they can only go to one country every five years. The Council never gets reports on how well are we doing in individual countries. So the Council wouldn't have had a way of knowing that we were a billion-plus behind in Japan, relative to our benchmark; that we owned a highly idiosyncratic portfolio in Japan. Actually, I believe you have a memorandum that was sent to Council members, outlining a longer list of these things -- so I don't want to take up more time here.

TREASURER McCORMAC: If I could, though, Assemblyman, just a couple of points on the operations, in response to your question.

Simple things we found out in some recent discussions: For example, that the actual timing of trades -- the Division meets weekly, on Tuesdays, and orders are cleared through this committee, and then placed, and then executed over the next several days. I don't know anybody, in my experience in the field, that only trades -- or only makes trade decisions on one day of the week. And not only that, but there's no limit order. So that on Tuesday, if you decide you need 500 shares of a stock, at $30, and you tell the traders you want to buy the 500 shares at $30, but by Thursday, when they execute the trade, it's $35, you may not want the stock at 35. You wanted it at 30.

So the basic operation of the Division, I think, is flawed, in that one day a week to make these decisions, and then, if Wednesday morning, Enron starts tanking, and you want to get out of it, you've got to go petition for special permission to make a trade, or discuss a trade on a non-Tuesday. I mean, when I talk about this with people in the industry, their jaws drop when they find out that this is the practice, that there's a one-day-a-week decision period, without special permission -- which is discouraged -- and the trades then, over the next day or two -- and who knows what happens on Mondays and Fridays. But that's just a very flawed system, and a very flawed operation that needs to be seriously looked at.

ASSEMBLYMAN SARLO: With regard to -- and I agree with both of you. This is not about the employees. We're focusing on policy.

But what kind of workload -- if I'm a portfolio manager, and on Tuesday I get my marching orders, what kind of workload do I have to, as stocks are high -- I mean, are they overworked? Is there a high workload there that they can't get to something until Friday, when there could have been something that went down the -- you know, I know my assets -- hopefully, whoever is watching my assets in my portfolio is looking at this every single day, while I'm down here doing the State's business. I hope they're looking at it. But is there a workload situation there, where they may not be getting to something later in the week?

TREASURER McCORMAC: There's certainly an issue of staffing. And we've had -- in discussions with Division staff, we recognize that some employees do have an incredibly large workload. One employee is responsible for 500 stocks. Now, on Wall Street, there's no such thing as an employee that has to watch 500 stocks. The number is a fraction of that in industry. There's one employee that has to manage $4.6 billion, in that sector. That's an incredibly large number to ask one employee to have to monitor.

So, as Mr. Kramer said, and you alluded to, the problem is not with the employees and their individual performance. The problem is with the system that allows one employee to be in charge of 500 stocks, or almost $5 billion worth of stocks. The system does not encourage discussions between employees. The domestic auto analyst does not have to, necessarily, coordinate his trades -- or her trades -- with the international auto analyst, so that at one point the domestic person could think Ford is a great buy, for his or her own reasons, and the international person could think it's a sell, for his or her own reasons, and they don't talk. That's not acceptable.

So, again -- and I'm glad you mentioned, it's not an employee problem. It's not a case -- if anything, there probably aren't enough employees in the Division.

ASSEMBLYMAN SARLO: And maybe nationwide -- I mean, in other public entities throughout our country, does anybody else follow the practice of this one-day-a-week type of meeting, where you've got to get -- once you go beyond that day, now you need special permission, especially if something has taken a significant downturn?

TREASURER McCORMAC: I have not come across any, nor in any of my discussions with IFS representatives, or Mr. Kramer, or anybody. We are, in fact -- there's two aspects of management. One is internal versus external, internal meaning we do it all in-house, without outside money managers; external being that -- an active versus passive. Active means we actively trade stocks in an attempt to outperform indexes, versus passive, which simply makes your portfolio match the S&P 1500, or the Lehman Index, or the Solomon Index. We're the only 100 percent actively managed, 100 percent internally managed fund in the country. And that, in and of itself, would give us pause and reason for concern that we are so far different from everybody else. In fact, there's 44 percent of the funds in the country that are totally externally managed. Of the ones that are not, of the 56 percent, 59 percent have some aspect of the external management. So when all is put together, only 24 percent of the funds -- of the moneys in these funds are actively, internally managed. And we are 100 percent, when the standard average in the country is 24 percent.

ASSEMBLYMAN SARLO: Mr. Chairman, last question.

From an operational standpoint that I have, at this time, what kind of interaction is there between the investment groups and the Treasurer's Office? Is there any reporting requirements of any kind? Are they -- any reporting requirement that they have to give to you?

TREASURER McCORMAC: There are requirements for, I believe, quarterly reports to be submitted from the Investment Division to the

Treasurer. I have, I think, been a little more active than, probably, past treasurers, and because of the losses, and looking at and asking for and demanding quicker and more expansive reporting, there is some. There should be more, and there will be more, as we go through this study, I'm sure. My concern is that we need to know everything quick, so that we can react, and I can't wait, necessarily, for a quarterly report to tell me that we lost money. So I certainly intend to pursue more aggressive reporting by the Division to the Treasury.

ASSEMBLYMAN SARLO: Thank you, Mr. Treasurer.

Thank you, Mr. Chairman.

ASSEMBLYMAN ROBERTS: Assemblyman, thank you very much.

Next is Assemblyman Gregg.

ASSEMBLYMAN GREGG: Thank you, Mr. Chairman.

Thank you, Treasurer, for being here. I think this is a purposeful meeting. It's always a good opportunity for the Legislature to hear from -- what's going on from the administration and from our entities.

I think having oversight is a very good thing. And I look at this Committee as a committee that can provide oversight, and I'm glad to hear that you're reaching out to Mr. Kramer and to legislators. I hope that I'm on your list so I can get a better feeling for this. I sense -- I have to share with you, I sense that we've come right out of the blocks here so quickly that this is not like a Budget and Appropriations Committee hearing that happens every yea,r that the members are usually fairly knowledgeable about each one of the different divisions. At this point, this is somewhat of a gray area to even some of us who have spent a lot of time in the budget process. So I hope we'll get some good questioning, and perhaps we'll continue this process even farther.

And I'm hoping, through the Chair, that we consider if this is a process that we move forward on making changes that may be needed, because it's always good to look to see if we're doing things right, that we have an opportunity to bring in one of our former leaders that virtually any of us, who served on Budget for the last eight or ten years, know Mr. Machold, an individual who has great expertise and experience in this. And I think it would be very purposeful to have him in front of this Committee, as one would say on the news, to hear, perhaps, the other side of the story, as someone who operated the fund through those years.

With that said, Treasurer, or Mr. Kramer, are either one of you familiar with New England Pension Consultants?

TREASURER McCORMAC: Yes, sir.

ASSEMBLYMAN GREGG: Who are they?

TREASURER McCORMAC: They are the Division's current consultant, engaged on an annual basis.

ASSEMBLYMAN GREGG: And how long have we used them, through the Chair?

TREASURER McCORMAC: Approximately, 1986.

ASSEMBLYMAN GREGG: So a decade and a half, a fairly long period of time. Now, are the consultants that we have here today, through this RFP, designed to replace these folks, or in addition to them?

TREASURER McCORMAC: No, sir, they're not intended to replace them.

ASSEMBLYMAN GREGG: So the --

TREASURER McCORMAC: That is a completely separate focus of the contract. The New England Pension is an operational performance measurement-type contract. This is a purely operational audit -- fiduciary audit.

ASSEMBLYMAN GREGG: So the new RFP is for a new review of our program, and New England is still part of our process.

TREASURER McCORMAC: Yes. But, again, there's two very different focuses between New England Pension and between Independent Fiduciary Services.

ASSEMBLYMAN GREGG: I understand.

TREASURER McCORMAC: Okay.

ASSEMBLYMAN GREGG: But we still have New England as our -- a company that reviews the productivity of our program. They will report again next year?

TREASURER McCORMAC: I'm not sure I'd use the word productivity, but they certainly report on performance.

ASSEMBLYMAN GREGG: Now, they've just completed a report, as I understand, that was issued to us in September. Would that be correct?

TREASURER McCORMAC: Yes, sir.

ASSEMBLYMAN GREGG: I am just -- because I have to be very frank with you, I received a lot of this paperwork, not weeks ago, which I may need to assimilate some of the charts and numbers that are here. So I go to, kind of, the big print and simple stuff. And I'm looking at a page from there, where it basically says, "Plan Performance Summary." And it says, "The plan has performed well over the longer term. Above average equity commitment has been -- benefited results for the long term, but has hurt near-term returns," which is somewhat what we have heard today in testimony. "End point sensitivity negatively impacts the performance appraisal. The plan has outperformed in five of its last eight years." "Active management," which is a term we've heard today, which for me means the fact that, basically, we're running it -- the State, as opposed to giving it to someone else to run -- "has added value in three of the past five years, five of the past ten years, and for all multiyear periods, three years on length or longer."

Now, as a person who got a number of report cards in my past, I call that a fairly good report card. Would you like to comment, before I go deeper into the report, which I plan on doing?

MR. KRAMER: I'm sorry, Assemblyman. What -- do you know what page you're reading?

ASSEMBLYMAN GREGG: Page 52.

MR. KRAMER: Page 52?

ASSEMBLYMAN GREGG: Yes, I'm sorry. And then, if you had it there, I would have grabbed it.

MR. KRAMER: Do you want me to take the first?

ASSEMBLYMAN GREGG: Yes. This is, from my standpoint, a comfortable setting. I leave it to the Chairman, but I kind of throw the question at the table. Anybody can answer it.

MR. KRAMER: Let me make a few general points, and then I'll respond specifically to each of these, because, actually, I'm glad you raised the question, because it raises several common misconceptions, which I think people in New Jersey are entitled to be subject to, because they're told these things.

First of all, we were told, at the meeting on the 19th, that New Jersey's long-term record -- it's 10-year record -- is unsurpassed by any other fund. There are a number of individuals who did not vote for me, who will confirm that that took place at that meeting, and it's actually part of the public record.

ASSEMBLYMAN GREGG: We all have that problem, with everybody not voting for us, up here. (laughter)

MR. KRAMER: I understand. In any event, I began assembling a list, and then I stopped. But funds that have had higher 10-year numbers than New Jersey, and also, higher risks than New Jersey: there's Cal-PERS, there's New York Common, there's Pennsylvania Teachers', there's Oregon, there's Washington, there's Massachusetts, Minnesota. At a certain point I just stopped, because, I said, you know, it's clear that we don't have the best 10-year record.

Specifically, if you want to compare us to funds where the average entity in the universe is, literally, a thousandth our size, then on a 10-year basis, we still have above average risk, but we also have slightly above average return. The reason that the large funds in the country all pay money to Wilshire, to have Wilshire collect that data on the funds above $10 billion, is because Cal-PERS and Callisters (phonetic) and New York and Pennsylvania, etc. know that that's a different business than running a $100 million fund, and they want to know what those other funds are doing, and how our performance stacks up against theirs.

On a 10-year basis, we're in the 18th percentile in that universe. And since there were a lot of adjectives used about the performance over the last three years, let me make it very explicit. They're actually five databases you can go to if you wanted to look at each one. And depending on which of the five databases you choose, in the worst case we ranked 98th out of 100, and in the best case we ranked 93rd out of 100. But we're buried somewhere down there in the bottom of the bottom decile. And there are no alternative databases that have, you know, any other findings.

Secondly, what New England Pension has said to New Jersey, and what a number of people have repeated in New Jersey is, "Look, we have a problem. We own more equities than other people. And because we own more equities than other people, we had great performance in the late ′90s, and now we're doing worse than other people." That is correct as a partial explanation of what's happened, because, over time, on average, we have owned more equities.

What isn't in this 60-chart, two-hour presentation that New England Pension produced is how have we done in equities -- just purely within equities -- compared to other, you know, other funds. And what you find is, within equities, alone -- assuming everyone's portfolio is 100 percent equities -- we're, again, somewhere around the 6th percentile for the last three years. We're in the 28th percentile, meaning basically the top of the bottom quarter, over 10 years. The numbers just simply aren't presented here.

As a matter of fact, if you go through and you look at every asset class -- you might say, the simplest way to describe what we've created by active management-- You know, there is no state -- there's been, as you know, all this public controversy about something that hasn't been put on the table by anybody to my knowledge, which is external management. There's the issue of indexing, which isn't politically interesting to people, which is actually very important. There is no state that tries to actively manage all this money. And the reason is, because all the academic research supports what we've gotten in New Jersey. What we've gotten in New Jersey is, if you compare us to all the funds in the country above $5 billion, either over a five-year period or a ten-year period, in every asset class -- in domestic equities, in international equities, and in fixed income -- we had both lower returns and higher risks than our peers -- five years, ten years, and actually, I didn't bother doing it for three years, because I thought it would be cheating, because our performance was so bad over three years.

So, Number 1, the 10-year record is not what it is -- the way it has been characterized. Number 2, we have underperformed in equities, and that, simply, is not material that is here. Number 3, one of the things that New Jersey has never done, which is common among states, is they have limits on what they call tracking error. That's really volatility, which is basically saying, "I don't know how you're going to make up the fund, but I want you to make up the fund so that the volatility, or standard deviation relative to the norm, isn't above some given level." That's common in large, institutional funds. New Jersey has never had limits on volatility and tracking error. It has never had measurements that went to the Council on volatility and tracking error, and so it shouldn't be surprising that New Jersey's volatility has been well above average over three-, five-, or ten-year period for any asset class you want to measure.

TREASURER McCORMAC: I just want to add one point on benchmarking. I've heard, too, that the ′90s were good. We were at the top. But what's alarming is that there was not an internally generated benchmark in the Division until the second quarter of 1999, and that was generated at 50 percent of the S&P 1,500; 15 percent for the foreign equity side, for the Morgan International Index; 30 percent for fixed income, from the Lehman Index; and 5 percent cash. This benchmark was not generated until the second quarter of 1999. So when people say we did great in the ′90s and great in the ′80s, there's missing, "compared to *blank*," and the blank would be an internal benchmark, or that blank would be something that's a fair measurement -- other states, other large pension funds, basic indexes -- that's always missing from the statement: This is how we did so great in the ′90s.

Well, we didn't even have an internally generated benchmark to measure ourselves until the second quarter of 1999.

ASSEMBLYMAN GREGG: I hope all the answers aren't quite that long. (laughter) We'll be here a long time.

ASSEMBLYMAN ROBERTS: We have plenty of time.

ASSEMBLYMAN GREGG: I just want to stay on the report, because it's clear that both you gentlemen are not comfortable with the company's report. But I think the folks here who are reporting it might want to hear more about the report that I heard Mr. Kramer speak -- that it didn't deal with the individual investment categories, the Fund As, Bs, Domestic Income, Foreign Income, Mortgage Portfolios. And I will not -- I will make this a statement, prior to a question, because I don't want you to just have to go back and give the same answer.

But basically, in every fund -- even though the foreign investment was far, far weaker -- that in the three- to five-year period that virtually our program was above average or very much above average. Not to say that there can't be improvements made. I go to the conclusions of the report -- and, again, this is a company that I want to reiterate for anyone who is writing stories out there, 17-years experience with us, through two Democratic governors and two Republican governors, that obviously these folks have had some respect and acceptance here. While, again -- and I'm hoping that the purpose of this testimony today, and further testimony, and the Task Force here is designed to improve what we have, because there's always a method of improving it, as opposed to attempting to completely redo it and discredit the program we have now, because I think that would be troubling to me.

Conclusions of this report: "The plan's long-term performance has been good. Overall, the plan's policies and approach is sound. The plan is well diversified. Alternatives could be considered, but there are many pros and cons.

"Poor short-term performance, explained by asset allocation, and to lesser extent, active management. Active management has added value, over the long term, largely due to extremely strong performance in ′98 and 2000 time period."

I'll asterisk, "The fee savings" -- and I'll asterisk, again, "The fee savings associated with the internal management have been very meaningful, approximately a billion dollars over ten years. Performance by asset class has been competitive to above average, except for the international," which I incorrectly stated as foreign, "Fund D."

And there are a number of recommendations, and I would be happy to read them, but I won't -- many that you have mentioned, Mr. Kramer, that I certainly may agree with. But I am troubled by the fact, when you watch a golf analyst, that they never pick on Tiger Woods' swing until he stops hitting greens. And I think that, perhaps, this meeting is a lot like that, that as long as we keep hitting greens, nobody bothers to go back and ask people to adjust their swing. And I'm hoping what we're here today to do is not to reinvent Tiger Woods' swing, but to perhaps look at, you know, how an existing program that brings us some benefits -- I mean, I think this -- I've, kind of, looked maybe from the other side of the aisle differently, as a person who has learned a lot over the last nine years here about things you should privatize and things you shouldn't privatize. And I'm the first one to admit it. And, sometimes I don't look at the issue of, just because we're the only people who do it, as a negative. Sometimes the only people who do something or don't do something might be a positive.

So I am somewhat troubled -- and I'm looking forward to hearing more answers and more testimony -- by the appearance that the folks out here are in a sell mode, as opposed to an informative mode. And I hope you're not. I really hope that you are in a open-minded mode to say that we're really talking about the people who are getting pensions here. We shouldn't be massaging numbers to show that the losses we have actually include payments to people, that we should be looking honestly about these numbers. We should look honestly at what the professionals that we've used for 17 years are saying, and not be troubled about bringing in someone new to give us, maybe, a fresh approach; but to remember we've had a very, very successful program.

And, Assemblywoman Quigley, you're right. We had tremendous benefits in the ′90s, with the program, in its growth and its ability to earn interest that afforded incredible increased pension benefits that many of us voted for, for the folks in that program.

And, now, we're in a time where there's been an economic downturn for a year or two, and we are immediately, perhaps in a knee-jerk fashion, but perhaps in a responsible fashion, saying, "Let's go back and look at it." I hope that's where we're going. I really believe we are, and I hope the tenor of the Committee here is really about giving this -- the members here -- more information to go back and massage, so we can continue this dialogue.

And feel free, Mr. Kramer, but I will turn my microphone off so we can have other people asking questions.

Thank you for your time.

MR. KRAMER: If I could just respond, at a high level of generality. Number 1, I would be delighted to sit down with you, members of your staff, other people who perceive that they have an interest and knowledge about this, and talk about it, not get stuck here on the details.

Number 2, let me just say something about process. Everything that I've said to the Council, I've put in writing to Council members. I've done that intentionally, because there's a lot of room for miscommunication in this area, and that doesn't happen when you put it in your own words.

We had a process in the Council, in the past, where the Council only met once every two months. I suggested to Council members, maybe, at least during this period, we want to accelerate that, meet on a monthly basis. There was general support for that. And I said our first meeting will be to talk about the fact that Dick Charleton's (Phonetic) presentation, from New England Pensions -- been, you know, handling New Jersey and Louisiana for many years -- and my presentation were very different in direction. And if you walked in the room, in good faith, and you basically don't know much about this, you would basically say there seem -- you know, there seemed to be some irreconcilable differences in how these people -- are they both playing with the numbers, whatever?

I wrote out a reconciliation of some of the differences in approach. And I said, "We're going to have a meeting on October 21, and we're going to talk about exactly this issue." Some people did not attend the meeting. I have no criticism of people not attending the meeting. They have other things to do in their lives. There was -- none of these issues that you're raising here, which, you know, we can't do in this setting -- none of them were raised at that meeting. A number of the people who have been most critical publicly, saying it's a great record, I would wish they would call and say, "Let's sit down in a room --" and I don't care if it's a private room, or they want to have reporters in the room and have it covered, but let's talk about these numbers so that we understand. If someone says, "You know, this isn't really my area. I don't want any people in the room. I want to do it privately," we could do it privately. That process has not been happening. And it's not because I haven't been available, and it certainly hasn't been happening at the public meetings.

The third general point, which is your point which I agree with entirely, it doesn't matter what the numbers are for the last quarter. It actually -- the centerpiece of the argument that there is a problem here is not because over the last three years we happen to be in the third percentile, or the fifth, or the sixth, depending upon which database you want to use. The centerpiece of the argument is, look at our volatility. Look at the kind of risks that we've never measured. Look at the kind of risk controls that all the other states have, that every major institution has, that New Jersey doesn't have. Look at the arbitrariness of the Tuesday rule. I'm fully sympathetic with the idea that we want to discourage overtrading, and we want to encourage long-term investment. But nobody in my world has that kind of peculiar notion of, "And the way we're going to achieve that objective is having you only make decisions on Tuesdays," which, by the way, is extremely demoralizing to the staff, because the rest of the week, no matter what is happening in the world, people -- I run an investment management firm. People who are in my business, one of the things that's enjoyable about it is the world is always changing. And people who sit there, in that Division, who can't act until Tuesday, the ones who actually really want to be engaged, it's extremely frustrating for them.

TREASURER McCORMAC: Permit me to make a couple of points, too, Assemblyman, if I could.

First of all, you made a statement about the numbers, and whether or not we did account for payments. I want to assure you that when we say what the fund lost, we mean purely what it lost, realized and unrealized net losses in the portfolio, regardless of the payments. The fund started, which is the benchmark used before January 1st, 2000, with $83 billion. It earned a little over 5 billion, and paid out a little over 6 billion, and it lost 25.7 billion in value during that time -- those recent 11 quarters. So, we absolutely, fairly report the numbers as truly what the fund lost. We do not double count or include the payments to beneficiaries in the losses. That much is clear.

Second, you referred to the conclusions on the New England Pension study. I look at Number 3, and I look at Number 4. Number 3 says the plan is well diversified. Number 4 says poor short-term performance is explained by asset allocation. Now, to me, neither of those two conclusions -- cannot be on the same page. If you have poor performance because of your asset allocation, you are not well-diversified. We are in domestic equities. We are in fixed income. And we are in international equities. We have no alternative investments, whatsoever. The average in the country is 7.2 percent of a public portfolio in alternative investments. We have 0 percent in alternative. We are simply not well-diversified.

The third point, a lot of mention is made of the word privatization, privatizing. That is clearly not the goal of this administration. That is clearly not the goal of the study. That is an aspect -- as we say, we are certainly different from everybody else. We do it 100 percent internal -- 24 percent nationwide, 100 percent New Jersey. That is unusual. It is an aspect we're looking at, internal versus external, active versus passive. No decisions have been made. Nothing has been prejudged. We've assured the employees of the Division that we value their time and their service to the State, and this is not an attempt to cost anybody their jobs or to privatize or to take anything away from those employees. That is clearly not the case.

And as I said before, I believe, if anything, we're probably understaffed, when one employee has to do 500 stocks, and one employee has to do $5 billion worth of stocks.

And the last point I'll make is that, already, in a half-hour here, this body has asked more questions of the investment performance than the Investment Council has asked in the last three years. I've read every single meeting minutes, bi-monthly, for the past three years. You have already asked more insightful and thorough and thoughtful questions of myself and Mr. Kramer than have ever been asked over the past three years. And that's alarming. That's part of the problem.

We simply can't -- the New England Pension consultant did a two-hour presentation, and nobody asked a question. Now, that is, I think, indicative of the leadership of the Council over the last several years, that they're simply accepting what the consultant says.

We're not accepting what the consultant says. Mr. Kramer did his own study, in a couple of days before that meeting, and refuted many of the findings of our own consultant. I think that needs to be brought out, that the Investment Council has oversight responsibility. The people who we have put on the board since taking office understand that. It's a very necessary function to set the policies and to evaluate performance against those policies. And in 30 minutes, there have been more questions here than there have been in three years.

ASSEMBLYMAN ROBERTS: Thank you.

Assemblyman, are you finished?

ASSEMBLYMAN GREGG: Yes, sir.

ASSEMBLYMAN ROBERTS: Treasurer, it's encouraging that the members of this Committee are so interested, but it is frightening that the members of the Investment Council haven't been more interested.

The reference was made to why we're here, what the purpose of this Committee is. And it, clearly, I think, is to acknowledge that we can do better. If we've lost $25 billion in the last two years, that has a severe impact on the degree to which we can provide benefits to people who depend upon them in the long term, and financial impact on this State, and on all of us who want to provide more funds for things that matter to us in the short term.

I think it's interesting to use the New England Pension consultant's report as a point of reference. They, to the best of my knowledge, have been retained by the State of New Jersey to do this evaluation and make this presentation, and it's sad that, as you described, there wasn't a greater level of interest and critique of their work. But I will tell you that my experience, as somebody who has been in State government for a period of time, and local government before that, is that if I were given the choice of having two entities evaluate the quality of our work in terms of investing the State's resources, and one was a company that we hired, and we paid $100,0000 to do an evaluation, and they recognized that they wanted to have the contract next year and the year after that and the year after that, the same contract that they've had for 15 years; and the other alternative was an independent vehicle that evaluates all of the pension funds, all over the country and could give us a more objective assessment, I think a reasonable person might lean toward putting more faith in the one that, if you will, wasn't on the New Jersey payroll, to provide those services.

Let me just see if I have a correct understanding here. If we look at the Wilshire universe of large public and corporate funds, which I'm advised is fairly comparable to where we are in New Jersey in terms of the size of our portfolio, for the three years ending June 30, 2002, we ranked in the 6th percentile, meaning that of the comparable funds, 94 percent did better than we did. And if you look at the last 10 years, with respect to that same universe, of the Wilshire universe of very large funds, we were in the 18th percentile, again, meaning that roughly 82 percent of the funds in that universe did better than we did. Is that a correct characterization of how well we've done over the last three years and the last ten years?

TREASURER McCORMAC: Yes. That's off the State Investment Council report of September 19. Yes, sir.

ASSEMBLYMAN ROBERTS: As I heard Assemblyman Gregg raising his questions about how well we've done, and, you know, it needs to be said, that the last 10 years have been extraordinary. I remember criticizing the pension bond initiative when Governor Whitman offered it, because it had rates of return that, historically, were unrealistic. Anybody could have done well investing in the stock market during the '90s. A chimpanzee, standing with the financial page open, throwing darts, could have done well.

The question is, how well have we done with respect to comparable funds, not how well we've done in the abstract? And I think it's appropriate to look, not at the totality of funds, and not to buy a consultant's report that potentially puts the best face on it, but to look at funds that are comparable to where we are in New Jersey, recognizing that we have a fiduciary responsibility not just to do okay, but to do as well as we possibly can.

I wanted to ask, Mr. Treasurer, for you to say a few words about the various reviews that you have underway. I know that Governor McGreevey has asked former Governor Kean, former Governor Burn, and, I believe, Alan Blinder to participate in a review of the State's investment practices and pension practices. You indicated the review that you have, already, underway and some things that you're doing internally and that the Attorney General is doing. Give us a sense of what each of those entities will have as their responsibility and their area of focus.

TREASURER McCORMAC: The Governor Kean, Governor Burn, Professor Blinder committee has been challenged with more of a global, overall analysis of the steps that the governor and myself, as treasurer, have taken with regard to the funds. We have provided them with details on the fiduciary audit selection process and the firms that we interviewed and selected. And, by the way, your point about independence in the study process is important, because IFS has no other interest in this for the State. They will come in. They will do the study. They'll be done. They'll leave and go to some other state. They will have no recurring interest in the State. They'll have no continued work, no reason to recommend *A* because they could bid on *A*, or *B* because they could bid on *B*. They come in, they're done, and I think that's also very important in what made that firm attractive.

But getting back to the Governor Kean, Governor Burn, Professor Blinder committee is, again, a global group that is going to look at the concept of the fiduciary audit, hopefully would endorse that if they believe that's something that we should have done.

And the second thing is the issue of ethics, disclosures. The Attorney General is studying that matter now, at my request, and is going to make recommendations as to, perhaps, some improvements in disclosures on the part of Council members, as well as Division employees. This is a very serious matter. This is a $60 billion fund, and I think disclosures here, more than many other places in state government, are certainly warranted.

And third, as Mr. Kramer alluded to earlier: the issue of corporate governance and the fact that we intend to take an active role in securities litigation. We can't sit by and let Adelphia lose $100 million, and Enron lose $100 million, and just fill out a piece of paper and send it in and get on a list. We have to, at least, look at these losses and make a conscious determination that we should or shouldn't be active. And there may be very good reasons why being active and not going after the company on that basis is appropriate. But, in all likelihood, there are quite a few cases where we should be active participants, in fact, if not the lead plaintiff in the class action lawsuit.

So the Attorney General is looking at that, and we will ask the Kean, Burn, Blinder panel to comment on that.

Those are the three global areas, I believe, that that body is looking at.

You mentioned the Attorney General. I think I answered both questions at the same -- that they are looking at ethics areas and an active securities litigation area.

ASSEMBLYMAN ROBERTS: Thank you. I think -- I appreciated the comments that, I believe, Assemblyman Sarlo made earlier, about the quality of the individuals that we have working as full-time professionals in the -- I guess it's the Division of -- is it the Division of Investment? Is that the proper title?

TREASURER McCORMAC: Yes, sir.

ASSEMBLYMAN ROBERTS: And as we talk about doing better, I think it's important that they not be maligned, because to the best of what I've learned, through the research that I've done, these are very dedicated, very talented people, who work very, very hard. I think that the issue is their conduct with respect to the management, the direction that they're given by the Investment Council.

Interestingly, I've looked at the kinds of disclosures that they need to make. Perhaps it's not a form, but I've learned that they need to advise their superior of any activity that they may have as an individual with respect to a company that the State is invested in, and need to solicit written permission before they are able to buy a stock that the State has taken a position in. And it seems that that's in good order, and perhaps that could be tightened up, as well.

But something that is very troubling to me, and I'd appreciate your thoughts, because I think this needs to be an immediate area of inquiry for the Attorney General, is the degree to which the members of the Investment Council provide next to no disclosure with respect to their activities. They, as you know, have to fill out a one-page form, which simply asks them to talk about areas that, if you will, brokerage companies or investment companies that they may have an involvement in, that may do business with the State of New Jersey. To the best of my knowledge, there's no disclosure with respect to securities held in their personal portfolio. There's no disclosure with respect to purchases or sales that are made. There's no specific disclosure with respect to anything, wherein they might, potentially, personally benefit by decisions that they're making on behalf of the State of New Jersey.

Treasurer, they fill out this one-page document, which I would submit is not worth the paper that it's printed on. Yet, if a citizen wants to serve on the State Arts Council, where they're not paid a nickel, they have to fill out a 10-page financial disclosure form, which asks them to detail every financial instrument or piece of real estate that they own. It occurs to me that we need to do better. And I know this is an area that the Governor has a great interest in, and I hope that the Attorney General will focus on this area immediately.

It's conceivable -- not to suggest impropriety -- but it's conceivable that members of the Investment Council will sit around and make a strategic decision about a company or about a sector, and then a member of the Investment Council would have the ability to make decisions with respect to their own investments that could potentially benefit them. There's the potential for members of the Investment Council to have access to initial public offerings and other things that are advantages that they will have that they may, potentially, receive inappropriately.

I'm not suggesting for a moment that anyone on the Investment Council does that, or has ever done that. But in the absence of full disclosure, there will always be questions about whether or not that conduct has been appropriate.

I'd like to know if you share that assessment, and if you have encouraged, as someone who has responsibility in this area, for the Attorney General to be as thorough as he can be in his review?

TREASURER McCORMAC: Yes, Assemblyman, I would concur with you 100 percent. There are, I should note, statutes that do prohibit such conflicts in the Investment Council laws, but certainly there are, as you said, far greater disclosures for people on boards that control no money and have no assets -- still have to disclose, as you said, real estate holdings, retirement fund holdings, cash on hand, things like that. The people on the Investment Council oversee, by virtue of the policy setting agenda, billions and billions of dollars of other people's money. So I would submit that perhaps their disclosure should be greater than that of the average person on a board in the State of New Jersey, and that even the standard form should be expanded because of the potential for conflict of interest.

So I would, 100 percent, agree with you. I asked Attorney General Samson, a couple of months ago, to look into that, along with other areas including securities litigation, right after the reorganization meeting, at which point six of eleven members were new on the Council. I issued a letter to them, through the Division director, reminding them of these regulations. So I would, 100 percent, concur with you that the Attorney General should take a very strong look at these ethics disclosures and make appropriate recommendations.

ASSEMBLYMAN ROBERTS: Thank you. It does seem, frankly, that the situation is upside down, in terms of there being, frankly, no level -- or limited level of disclosure there, when folks who serve in areas where their decisions will not impact or potentially benefit them in any way have a much broader sense of disclosure.

You know, we, as members of the Legislature, have to file, on an annual basis, a document that indicates sources of income and real estate owned, and things of that sort. And I think that there's a level of integrity on the part of the Legislature, just as there is on the members of the Investment Council. But knowing that that's an available public document, I think, does reassure the public that the decisions are being made for the right reason. And I thank you for making this a priority in terms of reviewing it.

That is all I have. Let me now turn to Assemblyman Burzichelli.

ASSEMBLYMAN BURZICHELLI: Thank you, Mr. Chairman.

And good afternoon to our two guests. Thank you for your patience and time. For some of us, a lot of this dialogue, it just takes a little more for us to absorb it.

And I want to back up a bit, because I want to ask a question about the pension bonds, which has always been of interest to me. I've served as a mayor of a municipality, and I was active with the League when all of the discussions were going on about whether or not that was a good idea.

But I just want to make a comment before I ask a question about the pension bonds, because I'm listening to Mr. Kramer discussing, within this Division, how we appear to be still working in the dark ages. And although some of the terms -- and I'd like to think I understand most of them, especially being able to sit through and listen to the detailed presentation you gave, Mr. Kramer -- I don't suspect that they're new terms. I mean, I don't expect they're recently released from the Wharton School of Business, when you talk about benchmarks and risk analysis and how transactions are managed. And I'm just curious as to how the State of New Jersey, having such a responsibility dealing with people's pensions, and with these individuals being full-time employees, not distracted by having to represent anyone else's interest, how that Division stayed in what appears to be the Dark Ages for so long. Is there -- is that just a rhetorical question on my part, or is there an answer for that?

TREASURER McCORMAC: I think it goes to the structure, the practices and procedures that worked in the ′90s. And as I think Assemblyman Gregg said, when things are good and Tiger Woods is hitting the greens, you don't tend to look. Perhaps such a look should have been made then, and if you look at Tiger Woods' swing when he's going good, maybe he hits 18 out of 18, instead of 16 out of 18. You still look, and the fact that he's doing good is not enough of a reason not to evaluate as you go forward.

So it's a system-driven problem, certainly not the employees, as we've all said. They just didn't react to the market declines that began in 2000 quick enough. It starts with the Investment Council setting the policies. The policies were not changed, despite the downturn in the market. And the explanations are always, "Well, it's only one quarter. It's the short term, don't worry." Then it became two. Then it became three. And everybody kept saying, "It's the long term, it's the long term." Well, the long term is a series of short-term results, and right now our long term, over the last three years, is not good.

And it starts at the top. And decisions were not made to change the policies. Decisions were not made to change the practices or to have this study done that we're going to do. And I think that's the problem.

ASSEMBLYMAN BURZICHELLI: Also, I'd like to add to that, it doesn't seem like the Investment Council had been very active, based on what you said. And we weren't always just living in the ′90s. There were years that happened before the ′ 90s that I would have to think, in peaks and valleys, that some of these shortcomings would have been exposed, and I guess you can go back further. That's why I say, I'm just alarmed that we live in the Dark Ages in such an important area.

And if I may back up, I'd like to work from notes here. As I mentioned, the pension obligation bond sale was of real interest to me and, of course, to many people around the State. I'd like to go back and ask a few questions of what was, arguably, the most controversial pension activity of the previous administration -- the Whitman administration -- the sale of the pension obligation bonds.

Since the proceeds of this bond sale were deposited into the pension system, I would assume they have been affected by the State's recent losses. I believe the State borrowed -- I have notes of 2.8 billion. What is the current value of the proceeds of the pension bond obligation sales?

TREASURER McCORMAC: The way to measure that would be to assume that, when the borrowing was done, that the funds were put in a segregated account, but earned the exact same rate of return as the funds, overall. And when you do that, from the date of borrowing on June 30, 1997, $2.803 billion was borrowed. The expenses of the sale were $53 million. So a net $2.75 billion was invested into the funds. Again, assuming that was self-contained and it paid for itself, it earned every quarter and paid the debt service every quarter, today that fund would be worth 2.79 -- September 30, I should say, it was worth 2.79. So roughly the same.

So the pension bonds that were borrowed, invested, and paid for themselves, clearly. But two other points are important. The State saved, since 1997 through 2003, approximately another $2.6 billion in payments, forwarded to today's dollars, which is fair to give credit for the fact that we now have more money in our pockets, because we didn't have to make those payments. So that's fair to put that on the positive side. But we still owe $9.5 billion in the pension bonds. There was 2.8 billion borrowed, and there's about a $10 billion or $11 billion total payback. As you know, with a mortgage, you buy a $150,000, and it costs you $500,000 by the time you're done in 30 years. Well, the 2.8 billion costs 10 or 11 billion over the 30 years. So we still owe $9.5 billion.

That present value is, to today, at 6.6, given account for the fact that the payment, year 25, is not the same as money in the bank today. So to be fair, you present value that back. So we have about 2.8 in the bank. We saved about 2.6. But we owe 6.6. So that's a net loser of about a billion dollars.

ASSEMBLYMAN BURZICHELLI: You know, I heard Mr. Kramer, earlier, use the term *bet* on a number of occasions, relating to transactions. And I want to say to you that my brother, who is -- works in labor management and works in the casino industry -- I would often ask him, as Atlantic City was growing, what's the largest casino. And he would answer, "Well, that's Wall Street."

And when I heard you say bet -- so I'm going to ask you, Mr. Treasurer, at this point, was the pension bond deal -- the sale of the pension bond obligation a good bet for the State of New Jersey?

TREASURER McCORMAC: As of today, no, sir. The bonds were sold at a 7.64 percent taxable rate, so the bet, if you will, was that over 30 years, the returns on the investments would exceed 7.64 percent.

Now, when I did financial planning, in a prior life, and somebody said, "Should I pay my mortgage off," the simple question is, what's your rate of your mortgage, and what's the rate you can earn. And if your mortgage is at 6 percent, and you can earn 10 percent, then you don't pay it. You pocket the 4 percent difference. If your mortgage was at 10, and you can only invest at 6, any investable cash should be used to pay off the 10, because it's higher than the 6. So that's a simple question, and the same analysis holds true with the pension bonds. If, in fact, you believe you would earn more than 7.64 percent over 30 years, why borrow 2.8 billion? Borrow 12.8; borrow 22.8, borrow all you can, if you really do believe you can exceed a 7.64 rate over 30 years.

I wasn't here in 1997. I don't know what, you know, was considered, but that's something that -- that's a bet. It's the gamble that was made that we're now going to pay for. Because as of five years and one quarter later, we have not earned 7.64 percent. In fact, we have to earn greater than 10 percent the rest of the way just to break even on that. And your guess is as good as mine as to whether we can earn 10 percent for the next 25 years. But the performance keeps raising the bar as to what we have to earn the rest of the way to break even. Will we earn 10 percent over the next 25 years? I wouldn't take that bet right now. I don't know that I would have bet on 7.64 percent five years ago. But, clearly, right now, the answer to your question is, we are worse off because of that gamble.

ASSEMBLYMAN BURZICHELLI: I think the only place we could find that kind of rate of return guaranteed is if we brought in as a fund manager, maybe, Tony Soprano and some of his people, to be sure of that kind of return.

Now, help me along here, if you would. One of the main reasons for the pension obligation bonds was to eliminate the need for a normal contribution to the pension system. When was the last time the State of New Jersey made normal contributions to the pension system?

TREASURER McCORMAC: The bond issue on June 30, ′97 negated the need for the contribution on that date. The date of the payment is June 30, so the last payment date was June 30, 1996. And we have not made a payment from ′97 through ′03. We will not have to make a payment in June of ′03. Fiscal 2004 is a completely different story. Every indication is that there will be a significant payment requirement in the State budget. We are waiting for our actuaries to get to us with the quantification of that number, and then we will make every attempt to manage that number.

But that's where the performance of the pension fund truly hits home, because it impacts not just the pensioners, but it impacts 8 million residents of the State of New Jersey, because it puts that kind of significant burden on us, as we manage the State budget, which, as you know, ′02, we walked in with $3-plus billion shortfall. In ′03, we face 6 billion; ′04 we're working on now. We've released some revenue. Certainly they're not coming in ahead of pace. They're slightly behind pace. We're very concerned about how ′04 looks. But your question hits at the heart of the problem -- the real problem with the pension fund performance -- which is on the State budget and the corresponding impact that will have on decisions we make on other revenues and other appropriations.

ASSEMBLYMAN BURZICHELLI: So I'll summarize then, and tell me if I'm incorrect in this summary. So the bad bet on the pension bond sale, we will make the first installment on the bad bet in the 2004 budget, which will be coming not very far down the road.

TREASURER McCORMAC: And keep in mind, we also still have to pay 25 years of debt service on that bond, and that's about 160 million in next year's budget by itself.

ASSEMBLYMAN BURZICHELLI: Do you have any estimate as to the level of additional assets which would currently be in the fund had the normal contributions continued to be made since the pension obligation bonds were sold? Or is that something that you could --

TREASURER McCORMAC: Well, we saved about $2.6 billion in contributions, so I'd say that's a fair number as to how much more would be in the plan if we would have made them. And the two numbers I put out before, had we kept to our own internal benchmark, we'd have 2.1 billion more in the plan. Had we performed in accordance with our peers, we'd have $7.3 billion more in the plan.

ASSEMBLYMAN BURZICHELLI: Very good. Thank you, Mr. Treasurer, and thank you, Mr. Kramer, for your -- thank you very much for your patience and testimony.

ASSEMBLYMAN ROBERTS: Assemblyman, thank you very much.

Next is Assemblyman Doherty.

ASSEMBLYMAN DOHERTY: Thank you, Mr. Chairman.

Mr. Kramer, Treasurer McCormac, good afternoon.

Mr. Kramer, the State Investment Council, could you tell me how that originated?

MR. KRAMER: I believe it was 1950, 1951. I'm not an historian on the subject, but I believe it was around ′50, ′51, there was some sort of a scandal in the State, and the State Investment Council was created to try to sanitize the investment process and depoliticize the investment process. I know that was the objective, but the precise circumstances --

ASSEMBLYMAN DOHERTY: So basically, in 1950, there were some political scandals involving political patronage, and the State Investment Council was created in response to these political patronage scandals that were occurring.

MR. KRAMER: I don't know what the facts were, but if you say that that's what there was, I believe you.

ASSEMBLYMAN DOHERTY: Okay. How much -- what's the budget of the Division of Investment, the annual budget for these folks that manage the State pension funds?

MR. KRAMER: I think it's around -- you know, I'm going to guess at this. Is it 30 million?

TREASURER McCORMAC: It's not measured.

MR. KRAMER: Oh, I'm sorry. That's their commission fee.

TREASURER McCORMAC: Yeah, it's about 6 million in the budget for things like salaries and other expenses. But I would submit that there's a bunch of hidden expenses that don't show, between $30 million and $40 million in commissions are paid that are netted against the trades and don't show as an expense. So, frequently, when somebody says we're very inexpensive, they look at the actual cost in the budget, but they don't look at other costs that are hidden otherwise. So it's more than a $50-million-a-year operation, but the direct number you see in the budget is only several million dollars.

ASSEMBLYMAN DOHERTY: Okay, because I was looking at this estimated fee. I guess this is the New England Pension Consultants report, dated September 19 of this year, on Page 24, and it points out, over the last 10 years, what the cost was for the State public employees to manage the pension fund, versus what the cost would have been had a private investment manager handled it. And it appears to be about a billion dollar savings by having State employees do it, as opposed to farming out this work to private investment consultants.

TREASURER McCORMAC: There is no doubt that we are, if not the least expensive, probably among the least expensive to operate, public pension funds in the country. That's clear.

But if you told me that spending that billion would have gotten us that 7.3 billion, just to be the average of our peers, I'd spend the billion.

ASSEMBLYMAN DOHERTY: Are you aware how Pennsylvania manages their pension assets -- the State of Pennsylvania?

J E A N N A M. C U L L I N S, ESQ.: Which one, sir, the state or the public schools?

ASSEMBLYMAN DOHERTY: The state.

MS. CULLINS: The -- when you say manage, do you mean internally, externally, passive manage --

ASSEMBLYMAN DOHERTY: Well, my -- do they manage it with public employees, similar to what New Jersey is doing?

MS. CULLINS: No. The public school does have some internal management, all right. And they are the larger fund. The Pennsylvania public school fund is the larger fund of those funds. So they do have some internal management, and they use external management.

If you want to really look at peers -- because we like to say when we look at pension funds, pension funds are like snowflakes, no two are really alike -- and when you start to scratch below the surface, you really -- you really get to look at the nuances. So if I were in your shoes, and I was going to compare myself to another pension fund, I would compare myself more to a Texas teacher's, all right, because they use -- at least until about two years ago, they used virtually all internal management. As a matter of fact, they have a constitutional limitation, all right. They're a little larger than you all are. And they use, on their equities, they probably use -- 50 percent of that is actively managed, versus 50 percent of what is passively managed.

ASSEMBLYMAN DOHERTY: So is the State of Pennsylvania using state employees to manage the fund, or private investment managers?

MS. CULLINS: The state is partial.

ASSEMBLYMAN DOHERTY: What does that mean?

MS. CULLINS: That means that they use internal management, i.e., they use state employees. And they use external management, which means they use outside money management firms.

ASSEMBLYMAN DOHERTY: Would it surprise you -- many people are criticizing the management of the Pennsylvania pension system.

They seem to be having less than average returns, and they've spent $325 million, annually, on private investment managers. And they're doing worse, on average, than other states.

What would you have to say about that?

MS. CULLINS: I'm looking at Pennsylvania's state allocation now. I don't have their returns with me. I would say it depends on how you slice it and dice it. Every pension fund,right now,is not doing well that had significant passive equity management. But when you say you're doing good or you're doing badly, it's relative to what, all right. What I like to do is, we like to look at your policy index, and what your policy index is, what you decided your asset allocation was going to be, and how well you're managing to the decisions that you made. Because hindsight is 50/50. And past good performance is no guarantee of future positive performance.

So, you know -- the City of New York, right now, is saying that it's got terrible performance. Pennsylvania is saying it has terrible performance. Cal-PERS is saying it has terrible performance. So, you know, if anything, I would caution you, when you say that, compared to what.

Now, is Pennsylvania probably doing better than you all are doing right now? I would say so. But is Pennsylvania a really good peer comparison to you all? Probably not. Pennsylvania public schools is probably a better comparison.

ASSEMBLYMAN DOHERTY: So, okay. What I'm hearing you say is New Jersey is doing worse than it has in the past with public managers, public employees, and Pennsylvania is doing not as good as expected with private investment managers.

MS. CULLINS: What -- again, we have to be very careful, because what's expected -- how are they doing -- what's expected, to me, is what their policy benchmark is. And I would like to look at them and say, "What is their policy benchmark." I mean, if you hear me -- I don't mean not to be responsive to you, but as someone who has sat on the other side -- because I used to run a pension fund, and I used to have oversight by the U.S. Congress, actually. I was the executive director of the District of Columbia pension fund. So I know what it's like to have your performance questioned. And you can slice and dice performance in a lot of ways.

So I'm very, very careful, and you should be very, very careful about how you look at the performance.

TREASURER McCORMAC: If I could, the bottom line is, we've heard the same comparisons to Pennsylvania, and it always says that New Jersey spent *X* million, Pennsylvania spent 285 million, but they never finish the sentence, in that, did they get a billion dollars worth of improved performance because of that 285, or did they lose the billion because of the 285. I'd love to see. I'd love to look at the Pennsylvania performance. And as Jenna said, let's match it up against Jersey where we can, where they're similar in terms of portfolio. But whenever somebody says Pennsylvania spends more money, they never complete the sentence and say, "But was it worth it." And in your case, on the billion, if we would have gotten performance for that billion dollars over the past 10 years, as New England Pension Consultants did, and if all that a different management style would have gotten us is the internal benchmark of 2.1 billion, I'd gladly spend a billion to make 2.1.

MS. CULLINS: The other --

ASSEMBLYMAN DOHERTY: Okay. Thanks.

Mr. Kramer, I have a question regarding the State Investment Council. What I'm hearing you say is that the State Investment Council is not reflecting the market, in that it only makes decisions weekly, or less frequently than day-to-day, as you may have a private fund manager do.

MR. KRAMER: That would be assuming that you're going to have an actively managed fund. I don't know any actively managed fund, either public or private, that operates that way. But I wouldn't say that that's even 3 percent of the ways in which New Jersey differs from every other pool of capital, every endowment, every university, every state, every major city. The whole series of risk controls that we haven't had in New Jersey, but --

ASSEMBLYMAN DOHERTY: I heard a criticism that the State Investment Council does not make decisions as frequently as other fund managers do. And your criticisim I heard was --

MR. KRAMER: No, no. Actually, the Investment Council, no one -- at least I didn't hear that today. The criticism was that among the many things that Investment Council members have learned recently, and I include past Investment Council members, who are very concerned to learn these things, is that there were practices which, at some point in time, someone from the Investment Council had known about, but which in recent years there had been no meetings between the Investment Council and the Division, so they wouldn't have known about it. And one of those practices is that the Division portfolio managers, basically, put in their trading orders on -- I believe it's Tuesday afternoon. And with exceptions, which are discouraged, and, therefore, there are rare exceptions, they don't go back on Thursday or Friday, and they don't have what the rest of us in the world use, which is limit orders. You know, if you think about it for a second, New Jersey is the only place in the world -- and, by the way, the academic who would argue that what New Jersey does makes sense hasn't begun writing yet; maybe they're in graduate school. Nobody believes that a group of people that small can actively manage that amount of money. That doesn't mean you have to give a penny to the outside world. That's why most people index, which is not politically controversial. It has nothing to do with external management.

Go ahead, I'm sorry.

ASSEMBLYMAN DOHERTY: It seems to me that an investment strategy is that -- you seem -- I heard, maybe I'm wrong, that this day-to-day decisions, you know, buying, selling, buying, selling, it's great to see on the financial cable channels, but any investment manager is going to say hey, you know, if you're a younger person, you want to invest in equities. If you're older, you want to be in bonds. And you buy and you hold for the long term in solid stocks. So this idea that you have to have somebody looking at the ticker 24-hours a day, it doesn't seem practical, in view of the advice that I see investment managers giving to folks.

TREASURER McCORMAC: I would completely and totally disagree. I would not ever give any of my money to a broker who only made decisions one day a week. If I call him up on Wednesday, because I heard Enron was going in the tank, and I say sell Enron, and he told me, "I will, next Wednesday," he wouldn't be my broker for long.

ASSEMBLYMAN DOHERTY: Well, that's a very big red herring. How much does the Standard and Poors turn over, the 500 Index? Does it turn over 50 percent a week, or do you see a very gradual, some are dropped, some are added on.

TREASURER McCORMAC: It's not a question of turnover. It's a question of commonsense portfolio management. And you cannot -- I cannot imagine a system that does not allow for trades --

ASSEMBLYMAN DOHERTY: Are there --

TREASURER McCORMAC: When I used to do stocks, I'd call up and say, "I want to buy this, I want to sell this." And a minute later, I'd get a call back, it's done. I didn't get a call back that said I'll get to it next week. That's indefensible. That's absolutely indefensible.

ASSEMBLYMAN DOHERTY: Are there provisions for calling emergency meetings? If you had $2 billion in Enron stock, could you call an emergency meeting of the State Investment Council, if you had to make --

TREASURER McCORMAC: No, it's not a Council issue. The Division and Council are different.

ASSEMBLYMAN DOHERTY: Well, if it was an emergency, and you had to unload it --

MR. KRAMER: No, actually, the answer --

ASSEMBLYMAN DOHERTY: -- you could call an emergency meeting?

MR. KRAMER: Just a second. Go back a step. First of all, you can always call an emergency meeting. Secondly, there are risk controls that we have put in place so that Council members will not have contemporaneous knowledge of what's in the portfolio, to avoid any possible unintended conflicts. So, actually, all of us can know what was in the portfolio two months ago. It's public information. But actually, I will never know that *X* is still in the portfolio today. So the circumstance probably wouldn't arise because of that new risk control.

Let me just comment on your point about Tuesday. I agree with you that you want to have a long-term investment focus. That does not mean that you're indifferent to news, or that you're indifferent to price, or you're indifferent to the kind of volatility, which, as you say, is noise. A stock can go down. I mean, there's a tremendous amount of academic work that shows that most movements in asset classes or individual stock has nothing to do with the real long-term value of that investment. But that's precisely why, if you thought that something was an attractive value at 30, and it goes down on what you consider to be noise, and it goes down to 25, that's -- you know, that kind of -- between 25 and 30, when you're going back up, that's a 20 percent move. You would want to be able to take advantage of that. And the current structure inhibits that.

You know, the deeper answer to the question is, most people don't think that somebody -- and it has nothing to do with the fact that New Jersey is one of the worst compensated set of employees in this area, you know, of any major state. Most people don't think it's possible for someone to run a portfolio one-tenth the size of the portfolios they're running, and that this whole discussion about how often they ought to trade ends up being nonsense, that a lot of it ought to be indexed. Because there are reasons why no -- there is no other pool of capital in the world where they attempt to do what they try to do on State Street. And that has not a thing to do with external management.

And I'd only note, since you raised the issue of external management: You know, I have tried to put all of these things in writing. I have never gotten any specific response to any of these issues, which I'd be happy to talk about -- disagree about policy all day long; disagree about the Tuesday rule, you know, all day long. There's never been any response to that.

What there's a big response to is something that no one has ever asked for, which is "privatization," or semiprivatization. Everyone wants to stoke up fears about an issue which has not been put on the table, and somehow, people are not willing to discuss the issues that have been put on the table, like the fact that, again -- you know, talk about the 1990s, New Jersey's is the only pool of capital that I'm aware of that went through the 1990s without a benchmark.

ASSEMBLYMAN DOHERTY: Do you know, Mr. Kramer, who Steven Kornrumpf is?

MR. KRAMER: Certainly. Oh, I'm sorry. He is the Director of the Division of Investments.

ASSEMBLYMAN DOHERTY: Okay. I've read information in the paper that there's been some pressure on Mr. Kornrumpf to resign from his position. It's my understanding that the State Investment Council appoints this individual. Is that correct?

MR. KRAMER: No.

TREASURER McCORMAC: First of all, I think we need to keep personnel discussions out of the public venue, out of fairness to the employees of the Division. The methods for --

ASSEMBLYMAN DOHERTY: Well, this was publicly reported, in a newspaper, that there's been pressure put on this gentleman to resign.

TREASURER McCORMAC: Well, it may have been reported, but certainly not attributed to anybody from this administration, and, therefore, we will not have any comments on personnel matters.

ASSEMBLYMAN DOHERTY: Okay. Is there -- it seems that the State Investment Council, it's under some attack here. Is this a laying of the groundwork for a reformation of the State Investment Council, to change the membership?

TREASURER McCORMAC: There are no plans to do so. I would look forward to working with the Investment Council in the future. There are several new members on it that have just been appointed. I value their position statutorily, legislatively, as a policy-making body. We will continue to have dialogue with them. As Mr. Kramer said, we've moved from bimonthly meetings to monthly meetings. And we have conversations with them, consistently, in between. And we value their input as we move forward and try to solve these problems.

ASSEMBLYMAN DOHERTY: Mr. Kramer, do you agree with that, that this is not a laying of groundwork for a transformation of the State Investment Council, so that you can control the appointments internally?

MR. KRAMER: Actually, first, on the narrow question you're raising, of the Division director, let me just restate the law. The law actually contemplates, in terms of the appointment process, something that's collaborative between the Council and the Treasurer. The Council -- because I've heard this stated, and I actually went back and looked at the statute. The statute does not say that the Council appoints the director. The Council provides recommendations to the Treasurer. The Treasurer may choose from the list of recommendations that comes from the Council. If the Treasurer doesn't like that list, he can ask for another list and another list and another list. That's all in the statute.

So it's a collaborative process in terms of who the Division director is.

ASSEMBLYMAN DOHERTY: So do you foresee a need, at this time, for changes to the State Investment Council, increasing its size or redoing it and having a new kind of Investment Council?

MR. KRAMER: I honestly never even heard that issue raised by any human being, in any private discussion, anywhere.

ASSEMBLYMAN CARABALLO: You got it here first.

MR. KRAMER: I mean, I've heard about a lot of things that, actually, haven't been put on the table that people want to talk about, but usually it's about external management. That's something that I had never even heard.

ASSEMBLYMAN DOHERTY: Okay.

Mr. Chairman, just one more question, if I may.

I understand there's a couple of unions -- strong unions in the State -- that are very concerned about the prospect of privatizing the management of these funds, in particular Communication Workers of America, Local No. 1038, and the N.J.E.A., which is concerned about the possibility of pension assets being utilized to subsidize political contributors. Do you have any comment on that? I mean, here's two very large unions that seem to be concerned about political contributors then being allowed to manage -- privately manage these funds, and is that the best way to manage the pension fund?

TREASURER McCORMAC: Well, first of all, I think the issue of privatization -- I think we've discussed. It's not the focus. It's not what we're thinking of. It's not the reason why we did anything.

Second, the issue of politicalization, we have no comments on people on the Council, before we got here, who are political donors and political fund-raisers, nor anybody since then. We value the opinions of the union. The fact that the Investment Council is made up of 11 members, 4 of which are appointed outside of the administration, directly by the union, is indicative of the importance of their input. It's their money. There's 600,000 people whose money is in this fund. We have reached out for all unions, on a consistent basis. We met with the executive directorship and the staff of one, at their offices, two weeks ago, Mr. Kramer and I and some other people from my staff went over his report. I went to one union myself, two weeks ago, and made a presentation to their board. I'm making another one in December, to make a presentation to their board. We've invited the unions in to look at all of the proposals we've received. Many have accepted our invitation. One, in fact, looked it over and said, "You made the right pick with IFS." We have agreed that among the very first interviews IFS will perform will be of the Investment Council members and the union representatives to the Investment Council and the union leadership. We take that relationship very, very seriously. And we will, again, make them a partner in this process the entire way through, and will keep them informed every single step we take, and we value those relationships very much.

ASSEMBLYMAN DOHERTY: Thank you.

ASSEMBLYMAN ROBERTS: Thank you, Assemblyman.

Next is Assemblyman Green.

ASSEMBLYMAN GREEN: This has been a very interesting afternoon. I would just like to comment on some of the questions, because some of the questions that were asked, I was going to ask.

First of all, I'd like to tell you that I'm very proud of you, the fact that you have come here and you have enlightened, especially me, on things, for the last 11 years as a member of this body, that I wasn't even aware. The reason why I say I congratulate you, because for the fact, coming, sharing this information with us, it gives us some direction exactly where you're going with this particular issue.

That's something very important, because the former treasurer had to come -- he had to apologize for some of the actions that had occurred the last couple of years.

I heard the comment about Tiger Woods. I like Tiger Woods. I'd like to talk about going to Atlantic City. I've got a problem with going down, gambling with my money, and that is what's happened the last two years.

So I would like to find out from you exactly what can we do to get out of the business of gambling? Not the fact that I'm not a gambler, but when you gamble with my future, you gamble with the ability of this State to function. And I think we need to take safeguards to make sure that doesn't happen in the future.

I don't want to get into being negative. I heard about what happened five years ago, with the investigation. We understand, you know, why that was said. The kind of money we've lost these last two years, there should be an investigation.

Number 2, if there's thoughts about replacing individuals on the Council, we need to talk about that, because it's obvious they didn't do a good job.

But I want to get, really, from you, in terms of where do we go from here, because at the end of the day, this is so important because of the fact that, like you said earlier, if we're going to invest dollars and manage our money a lot better, that's a great investment. That's better than gambling. And if that's the direction we need to take, then we need to hear about exactly what you feel you foresee we need to deal with in order to safeguard the people here in the State of New Jersey.

TREASURER McCORMAC: Well, I think Assemblyman Burzichelli's comment on, you know, Wall Street being a bigger gamble than Atlantic City is true to an extent. Anytime you invest in stocks, even in fixed income, it is, to an extent, a gamble. I don't think any pension, or anybody in the pension plan would want us to sit back and put the money in CDs, and, right now, earn one-point-something percent and think that's acceptable for when they retire, or the day they retire they'll have less money, in today's dollars, than -- which would not be good.

There's got to be some aspect of risk in any pension fund. There's got to be stocks bought. You hope they go up. There's got to be bonds bought. There's got to be foreign equities bought. So there's always going to be an element of risk. The issue is, you have to know that risk, you have to measure that risk, and you have to measure your performance against the risk that you took. And that's what's not being done now, whether it's the market segment, whether it's an industry, whether it's by employee, whether it's an international country, no one is ever saying, "Here's the risk we're taking, and here's the return we get."

If you gave me $2,000 for your IRA to invest, and I took it to Atlantic City and put it on red and won, and you had 4,000, you came back the next year and said, "How'd I do?" And I said, "You doubled your money, Jerry. It's great." And you said, "How'd you do it?" And I said, "Well, I bet it on red," you'd take the 4,000 and leave and you wouldn't come back to see me again. So that's the kind of analysis that we have to do on our portfolio. What risks are we taking in domestics and in fixed income and in foreign, and are we getting compensated for that risk?

And I can't say there's never going to be any, because that wouldn't be a pension fund. Pension funds are going to buy stock. Every stock goes up, every stock goes down. You have to just know what you're doing in advance. If someone wants to buy stock, they better be able to tell you why they want to buy it. They should be able to tell you how much they want to buy. And they should be able to tell you why they're still holding it. And when they want to sell it, they should be able to tell you why they're selling it and how much they're selling.

Those are questions that aren't being asked right now. And as Orin Kramer said, you're overweighting in industries, overweighting in countries, and it's fine if you do, but you ought to know you're doing it, and you ought to know why you're doing it. So I can't say there's ever going to be a portfolio that has no risk; that's impossible. You just have to know what -- go in with our eyes open and measure our performance against that risk to see if we got adequately compensated for that. And none of that's being done now.

ASSEMBLYMAN GREEN: My last question:

I'm sorry, Mr. Kramer, did you have a question, or a comment?

MR. KRAMER: Yeah, I do. If I -- only because this has been coming up in different forms. You know, Number 1, while there are a series of issues which are genuinely unique to New Jersey, or relatively unique to New Jersey, this whole issue of public fund losses -- forget that Jersey's had greater losses the last years -- but public losses, corporate losses, and the fictional assumptions that it had been permissible under past accounting for what the future gains were going to be, that whole system is going to get unraveled over the next couple of years. And even if we didn't have distinctive issues here in New Jersey, which we do, that the subjects that we've been talking about, I think it's going to be a massive public issue over the next three or four years, even if we indexed, even if we were normal, looking forward, and we had all the risk controls, etc.

Secondly, I just wanted to get on the record, since I have to work with the existing Council members including the past Council members, that at least in some cases, some of the Council members who regularly return my phone calls, they are genuinely -- and I'm talking now about past Council members -- genuinely disturbed about what they've learned recently, and the structural issues that it's raised. And I'm including good, strong Republicans here.

I think what happened -- I think there's a reason why everyone seizes on Assemblyman Gregg's metaphor -- we were winning tournaments. But there is an additional component, which is that probably among some people -- I don't say probably, because I think we all know some of these people -- among some people there was, and remains, genuine powerful pride in how this structure operated for years. And one might argue that people who felt such great pride in the system might have had a disinclination to look under the hood at some of these structural issues.

I think the reality is, it doesn't matter how people try to change the subject and turn to issues which aren't on the table about external management, or whatever. All of these things are so obvious, and the consequences are now coming home to roost, that to answer your basic question, which is, is anything going to happen, well, I don't want to speak for the Council. I think that in terms of certain areas, traditional, commonsense, widely adopted risk controls, over the next couple of months, that's going to be happening at the Council.

ASSEMBLYMAN GREEN: One last question: I have a lot of respect for Assemblyman Guy Gregg, because, as a small businessman, it's always the bottom line. But I think, in this day and age, in order to survive in business, and if you have that business concept about life, then I would like to get a feel, in terms of when you mention we have a small amount of individuals managing, say, 500 different stocks. And then we talk about bringing in people to help us manage this whole specific situation. In business, this is the way you have to go, in terms of making sure you have staff, because at the end of the day, if you have the right kind of staff, then you're going to get the right kind of product. In terms of bringing in professionals to help you in this particular area, this is an investment on your investment. And I would just like to feel, exactly, where are you headed in these two areas that I'm talking about?

TREASURER McCORMAC: I think the fact that we've got the operational auditor is an indication of where we want to head. And we want to head in the direction that evaluates, independently and objectively, what's going on. And we want to evaluate our systems. We want to see, are we adequately staffed? Does our staff make enough? Should they be getting incentive compensation, besides the top two people, perhaps further down the line, in some kind of performance, based on those? Are there enough? Are they given adequate access to research? Are they given adequate training?

As we said, many of the problems we know already, as far as measurement and performance evaluation, we know they're areas of concern. Is our accounting system fair? Is the way we reward brokers, through commissions, fair? These are things we don't know yet. We need this firm to come in and give us a good, solid, independent evaluation, as experts. They do this all over the country. They do nothing but this -- nothing but operational audits of pension funds.

That's where we're heading. We're heading in the direction of a 90- to 120-day study that will answer all these questions and tell us why we're doing as bad as we're doing, compared to our peers.

ASSEMBLYMAN GREEN: I think you're heading in the right direction. And if someone else has anything better, from a business point of view, then I would like for them to share with you. But I think just the mere fact you come in today, laying out a plan, is a move in the right direction. And I fully support that.

TREASURER McCORMAC: Thank you.

ASSEMBLYMAN ROBERTS: Assemblyman, thank you very much.

Assemblyman Caraballo.

ASSEMBLYMAN CARABALLO: Mr. Chairman, I really don't have any questions. I just want to make a statement. And that is that I sat here thanking my lucky stars that I took up law rather than the business of trying to manage people's money, which is another way of, basically, saying, trying to manage people's lives. At the end of the day, the people who wind up being affected by the decisions you make are those people who place a great deal of trust in not only you, but in those of us who sit up here.

Some of the materials that I've read, some of the testimony I've heard today and at various other times, is a little disturbing from the perspective of how we do business. But I am really pleased with the fact that you're asking the questions. I have no doubt, as Mr. Kramer said, some of the answers might not be the answers that you necessarily want. But the mere fact that you're willing to ask the questions becomes important to all of us. And

I exhort you to continue to do that, because at the end of the day, if things should stay the way they are, then we should know that. But if they shouldn't stay the way they are, then you have an obligation, I think, to tell us that.

And so I exhort you to continue asking those questions.

TREASURER McCORMAC: Thank you.

ASSEMBLYMAN ROBERTS: Assemblyman, thank you very much.

Assemblyman Gregg.

ASSEMBLYMAN GREGG: Thank you, Mr. Chairman.

I'd like to thank you, too, Mr. Kramer. I think your testimony today has been instructive, as well as very forthright. And I appreciate that. And I look forward to calling you up on that meeting.

Just one question for you. You say that there is some progress occurring, and that some changes will occur. So the Council is -- and for lack of a better term -- bending to some of your thoughts and are beginning to take some of your ideas, which, from what you said today, do make sense to me. You say some of these actions will occur? A couple of the things you've harped on, I think you've won the day on, is the Tuesday issue, and some of the issues of the protections. Those two issues, specifically, can you tell the Committee that there will be some changes, quickly?

MR. KRAMER: I don't want to speak for the Council, but actually -- you know, it's not about my leadership skills. I think that people who have been on the Council, not just the new members, but at least some of the older members, just didn't know about some of these issues. And it's like yourself, if somebody says, "We don't have disclosure about the size of industry bets," you know, we can debate how much of a limit we want to put on their industry bets, how good do we think that the people are likely to be. But, particularly, if we didn't have any limits, then we'd at least want to know the disclosure, so that assuming that all 11 Council members were, now and in the future, just frogs on a log, at least somebody in the room would ask a question, like, "Just tell me why we have this large bet here, and since, you know, if we're doing well, are we supposed to be taking something off the table. Is it still cheap? Or, if we're losing money, why don't we talk about it."

And as you know, the very fact of disclosure, even if the Council added no value to its discussions, ends up changing the dynamic of what takes place within the Division.

And I was also thinking, in listening to some of your comments, that for any of us who have done any form of public service, there are only subjective judgments we can make -- that others will make -- about whether you're doing a good job or not doing a good job. One of the things about money management is that people actually do have quantitative benchmarks.

One of the issues raised is the managers in New Jersey don't have agreed, quantitative benchmarks. Once somebody hears that, and you say, "Why don't we have a process, where, in advance of the year, we say this is the benchmark you'll be graded against." The Council will, actually, publicly recognize those managers who have performed best, and you'll have the satisfaction -- because until we change, we're not paying them very much -- you'll have the satisfaction of knowing that you performed well. And for people who say there can, really, be an economic incentive, if they create enough years of good performance, maybe they want to go somewhere else, and that's why you'd want to have a grading system. Jersey doesn't have a grading system.

ASSEMBLYMAN GREGG: Thank you, Mr. Kramer. I must just close with, we really have to stop using the word *bet* here. I think it's going to be frightful for people realizing our pension program bets on things. That's for the members of the press here.

MR. KRAMER: The formal word that I have, you know, used in writing, was overweight. And I just didn't want to keep talking about overweighted positions, and have someone not be --

ASSEMBLYMAN GREGG: That may be another term we shouldn't use, but that's okay. (laughter) I'm sorry -- no, I'm not. I have one real question.

This is just for Ms. Cullins. You have done this for any number of states.

MS. CULLINS: Yes, sir.

ASSEMBLYMAN GREGG: And the RFP that we asked you to do, without getting overly specific about it at all, but other states have asked you to do similar types of work?

MS. CULLINS: Yes, sir, definitely. We're doing it now for New York City, through the controller's office for the five funds. We're doing it now for the Alaska Investment Board -- we're finishing that one up now -- for the New Hampshire retirement system. We've done it for Virginia. We've done it for Washington State.

ASSEMBLYMAN GREGG: I'm not questioning your credentials. I was just curious, did anybody do Texas?

MS. CULLINS: Yes, we did Texas -- Texas teachers'.

ASSEMBLYMAN GREGG: Perfect. So you did Texas.

MS. CULLINS: Actually, we did Texas teachers' twice.

ASSEMBLYMAN GREGG: Okay, so you did Texas teachers' twice.

MS. CULLINS: Yes, sir.

ASSEMBLYMAN GREGG: Could you just give us -- and I know that the Chairman wants to leave -- but you did say that Texas was similar to us. Could you just tell us, very quickly, without making Texas look good or bad, you went into Texas -- the first or second time, whatever it may be -- and perhaps a couple of the recommendations you did for them, and if they took any?

MS. CULLINS: Well, that's why we went in for the second time, because I wasn't there when they did the first one in 1996. We came in the second time to see if the recommendations had been -- and we were hired by the state auditor's office -- if the recommendations had been implemented. A lot of them were.

One of the first recommendations in the 1996 report was that they were understaffed, and the staff was undercompensated. That is particularly critical when you talk about using internal management. And at that particular point, in 1996, they were 100 percent internally managed, all right.

In order to have internal management, you have to have people who have skill and expertise. That costs money. And those individuals were subject to the state's pay scale. So that was one recommendation, to get them out from under that. And the Legislature did, in fact, go along with that.

Another one of our recommendations, frankly, was that they should be allowed to use external management for at least the more difficult asset classes. And when I say difficult asset classes, I'm not necessarily talking about domestic equities or domestic fixed income. I'm talking about international, because the problem there is lack of resources. You know, if you can't travel and meet with these companies, it's very, very difficult for you to do the necessary research on them.

MR. McCORMAC: I may also add that that's a similar recommendation made by New England Pension Consultants, as far as outsourcing international, on Page 61. So that is very consistent.

ASSEMBLYMAN GREGG: Thank you, Mr. Chairman.

ASSEMBLYMAN ROBERTS: Assemblyman, thank you.

Mr. Treasurer, we've admittedly had a dreadful two years, with a loss of about $25 billion. I wonder if you could give us a sense of how that might impact on the State budget, going forward, particularly the one we're looking at, beginning next July?

TREASURER McCORMAC: Well, it certainly has an impact, the exact measurement of which has yet to be done. The payments to the pension plan depend on the value of the assets and the unfunded liability and the existence of a net assets fund, and the performance has wiped out that fund and we'll certainly, at least actuarially, be required to make a contribution in the Fiscal 2004 budget. This also has an impact on local governments, counties, which will also have to make contributions in the near future -- not 2003 -- April 1, 2003 is the municipal payment. That is clear. There is no payment due then. But just as we have to make a payment in June, 2004, so will municipalities and counties have to make a payment in April of 2004, to some extent.

Once that liability is determined, we will take every step we can to manage it. And there's a lot of options available to us that we will address. We'll work closely with the actuaries. We will keep the Legislature informed, naturally, through the budget process. But we will have to manage that liability. That's a significant -- a very, very significant impact on our State budget and the ability to deliver other services and other programs, because of this bad performance causing this contribution, without a doubt.

ASSEMBLYMAN ROBERTS: As you said, where the question's asked, why is this an appropriate area of inquiry, and why is it that we need to strive to reform this system and do better, it's because it has impacts like this.

Do you have an estimate of what the potential liability might be for the State in next year's budget?

TREASURER McCORMAC: Well, I'm only a couple of weeks away from receiving the actuary's report, so we have not necessarily publicized, in detail, what we think the problem will be, and I would hesitate to do that just yet. When that report is issued, it will be public, and it will be available, and we will address, with you, those findings. But I would hesitate to put a number on it now, because the work is still being done, and I hate to make a guess or be far off. So I'd say, with all due respect, if we could wait a couple of weeks, we will have a more firm answer from our experts.

ASSEMBLYMAN ROBERTS: Fair enough. Just as we conclude, we -- let me address my comments to the members of the Committee, particularly. We had Mr. Zoffinger, on behalf of the Sports and Exhibition

Authority, in to meet with us a few weeks ago. And one thing that was clear was that one of the contributions we can make to the budget process is to give the Budget Committee, or some arm of the Legislature, the opportunity to interact with the autonomous authorities, independent authorities, because they drive so many of the decisions that affect, you know, the quality of life in this State. And it's clear that, just as the Treasurer is now working more closely with the Investment Council, it's an area that we should pay more careful attention to, as well.

So this has been very, very informative, and I thank you all for being with us today.

Thank you very much. We're adjourned.

(MEETING CONCLUDED)